THE OFFSHORE BENEFICIARY PROVISIONS AND BENEFICIAL LOANS

Robert Venables QC[1]

1. Overview

The Offshore Beneficiary Provisions[2] can operate so as to impute chargeable gains realised by non-UK resident trustees to persons, whether beneficiaries (or others), who, directly or indirectly, receive (or are deemed to receive) 'capital payments' from the trustees: TCGA s.87(4). There is much controversy as to whether a capital payment which consists of the making by the trustees of a beneficial loan to a beneficiary constitutes a capital payment of any value. The view which I expressed in my *Tax Planning Through Trusts*, published by Butterworths in 1982, shortly after the provisions were originally enacted, was that in the case where the loan is interest-free and repayable on demand, it cannot. The Revenue view is firmly to the contrary. This view appears to be shared, or at least acquiesced in, by a majority of the Revenue Bar, although opinion amongst tax practitioners generally tends to be more divided. Realistically, I accept that there is a real possibility that if the matter came to litigation the view of the Revenue would prevail, partly because of the in-built advantage the Revenue enjoy before modern judges in any case which smacks of tax-avoidance, and partly because those very judges are themselves recruited from the Bar.

Not less important is the question of valuation of any benefit which may be conferred. There are some powerful legal arguments against the stringency of the current Revenue practice which, if successful, could often reduce the charge considerably, even if the Revenue are right on the main point. The difficulties of valuation are also relevant in arguing that the Revenue are wrong on the main point.

One particular case where opinions are sharply divided is where a loan is made to the tenant for life or other beneficiary entitled to an interest in possession and who

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1 Robert Venables QC, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ
Tel: (071) 242 2744 Fax: (071) 831 8095
Consulting Editor to this Review.

2 TCGA 1992 ss.87-98, formerly FA 1981 ss.80-84. In the Fifth Edition of my *Non-Resident Trusts*, updated to the 1993 Budget Speech, Chapter 14 is entirely devoted to the Provisions. References in this article to the Fifth Edition will be abbreviated as "NRT5".

is entitled to the income generated by the loan or would be so entitled if there were any.

2. The Need for a Test Case

Any taxpayer who challenges the Revenue knows that he has a fair chance of finishing up in the Court of Appeal. In most cases, the amounts at stake are comparatively modest, so that taxpayers feel compelled to give in. The Revenue thus have in practice virtually the same advantage as if they had fought and won a case. Not so long ago, I was myself instructed to argue the point before the Special Commissioners in a case in which the amounts involved were very considerable. Regrettably, from the point of view of taxpayers generally, the appeal was compromised. This is just the sort of point where it would be in the interests of a group of taxpayers to get together and finance a test case which could ideally raise all the points of principle.

3. Nature of the Article

Normally, an article in this Review would be of an academic nature, dispassionately considering the arguments on both sides of a disputed question. Given that the issue is a live one and I have advised professionally clients who may ultimately litigate the matter, it would not be appropriate for me to put the Revenue side of the case too impartially. Fortunately, there are many others who seem prepared to do just that. This article is therefore more in the nature of a pleading in litigation on behalf of the taxpayer. I shall merely set down some of the arguments in support of my view without indicating my estimation of their relative strengths and weaknesses.

4. The Scenario

The situation I am envisaging is one where the trustees of a settlement make a loan to a beneficiary[3] free of interest, or at a rate of interest less than would be agreed between parties at arm's length, and the loan is repayable on demand. If the loan is not repayable on demand, then there is an immediate diminution in the value of the trust assets and an immediate benefit is conferred on the beneficiary. To take an extreme case, if the trustees were to lend money to a beneficiary interest-free on terms that it was not to be repaid for fifty years, the value of the benefit would be almost as great as the amount of the money lent. I also assume that the beneficiary is good for repayment, although, in my opinion, that does not in fact in law make any difference.

5. The Statutory Provisions

Section 87(4) is the central provision:

> *"... the trust gains for a year of assessment shall be treated as chargeable gains accruing in that year to beneficiaries of the settlement who receive capital payments from the trustees in that year or have received such payments in any earlier year."*

Hence, we know that the capital payments must be received "from the trustees". There is only one gloss on this: as from 1991/92 payments received from "qualifying" companies controlled by the trustees are deemed to be payments received from the trustees.[4] This gloss does not, however, affect the general principle of interpretation.[5]

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3 Since the passing of FA 1991, the borrower need not in general be a beneficiary: see NRTS 14.16. Nor need the loan always be made directly by the trustees or directly to the beneficiary: see NRTS 14.14. and 14.15.

4 FA 1991 inserted in FA 1981 s.82A(1). See now TCGA s.96 and NRTS 14.14.

5 Lawyers will be familiar with the basic principle that it is not in general possible to construe an earlier statute by reference to a later statute: hence one cannot construe FA 1981 in the light of FA 1991, even as respects 1991/92. I make no excuse for restating this important principle as much of the advice I received à propos of *Marshall v Kerr* (after the taxpayer's defeat before Harman J and before his victory in the Court of Appeal) in articles written by non-legally qualified tax experts acting as back-seat advocates betrayed a fundamental ignorance of the canons of statutory interpretation upon which the case turned. One commentator actually suggested that this appeal against an assessment for 1983/84, which both the Revenue and myself agreed turned on the true construction of Finance Act 1965 s.24, should have been decided in the light of Finance Act 1988!

What is a "capital payment"? TCGA 1992 s.97 attempts a partial definition. It provides:

(1) In sections 87 to 96[6] and this section "capital payment" -

(a) means any payment which is not chargeable to income tax on the recipient or, in the case of a recipient who is neither resident or ordinarily resident in the United Kingdom, any payment received otherwise than as income, but

(b) does not include a payment under a transaction entered into at arm's length if it is received on or after 19th March 1991.

(2) In subsection (1) above references to a payment include references to the transfer of an asset and the conferring of any other benefit, and to any occasion on which settled property becomes property to which section 60[7] applies.

(3) ...

(4) For the purposes of ss.87-96 the amount of a capital payment made by way of loan, and of any other capital payment which is not a payment of money, shall be taken to be equal to the value of the benefit conferred by it."

It is subs. (4) which is *prima facie* the most relevant. It presupposes that there can be a capital payment which is made by way of loan. It states that the amount of a capital payment made by way of loan shall be taken to be equal to the value of the benefit conferred by it. Now the mere fact that a capital payment made by way of loan can confer a benefit, and a benefit of a quantifiable value, is not disputed. An interest-free loan for a fixed period would certainly confer an immediate benefit.

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6 The Offshore Beneficiary Provisions.

7 i.e., when a beneficiary becomes "absolutely entitled" to it within the meaning of TCGA s.60, so that it ceases to be settled property and the trustees are deemed, by TCGA s.71, to dispose of it to the beneficiary for a market value consideration (unless an election for hold-over relief is made).

6. The Scheme of the Provisions

One argument, admittedly of a broad-brush nature, rather than technically refined, but which might nonetheless succeed before judges who prefer common sense to technicality, is based on the scheme of the provisions. Capital gains tax is a tax on capital gains: *Aberdeen Construction Group Ltd v IRC* [1978] STC, 127 HL. The legislator decided, wisely or unwisely, that trustees who are non-UK resident shall be no more liable to tax than any other non-UK resident. He therefore somehow had to prevent tax avoidance by UK resident beneficiaries *enjoying* - I emphasise that word - tax-free gains of non-UK resident trustees. If and so long as a gain realised by a trustee has not been transmitted to a beneficiary, no harm is done. If, however, the beneficiary in fact receives a capital gain realised by the trustees, then it is just that he should pay tax on it. Until that happens, however, there is no injustice in his not paying tax. After all, the general principle of income tax law is that the income is not taxed until it is received see, e.g., *Parkside Leasing v Smith*.[8] In many types of trust it is difficult to say shortly after a gain has been realised by trustees which, if any, of the beneficiaries currently in existence will receive it. The Offshore Beneficiary Provisions, therefore, understandably proceed on a wait-and-see basis. As and when a beneficiary in fact receives capital, a capital gain is imputed to him. The capital must be distributed sooner or later unless it is lost, for example by bad investment. In that case it is just that no one should pay tax on so much of the gain as is eventually lost, as no beneficiary will have enjoyed it. Under this scheme, the Provisions do not envisage the taxation of a beneficiary on an income benefit as though it were capital gain where the conferring of that benefit involves the retention by the trustees of the capital gain realised by them.

It might be objected that s.97(1)(a) is not helpful. If "capital payment" is defined to mean any payment which is not chargeable to income tax on the recipient, does it not follow that income benefits are caught provided they are free from income tax? My answer is that the first limb of s.97(1)(a) is there merely to ensure that a payment which is chargeable to income tax on the recipient (even though it might be a capital payment for trust purposes) is excluded from the operation of the Provisions: otherwise there would be double taxation. This is simply the technical counterpart of TCGA s.37 (exclusion of consideration charged to income tax, etc., in computing chargeable gain on disposal of asset).

Moreover, the draftsman has then gone on to consider one obvious case where a benefit of an income nature might escape liability to income tax, namely, because it arose to a non-UK resident, and where the test of chargeability to income tax is not entirely appropriate, and has expressly stated that in such case a payment will be a capital payment if it is received otherwise than as income. The draughtsman can hardly have intended that an income benefit which is not chargeable to income

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8 [1985] STC 63.

tax in the hands of a UK resident should constitute a capital payment if the recipient happens to be a UK resident but should not constitute a capital payment if the recipient happens not to be.

If the contrary view were correct, it would follow, for example, that a person who was dual resident in the UK and a DTT State and who was deemed for the purposes of the DTT to be resident in that other State might find he was taxable on trust income in that other State alone under the terms of the DTT but was also liable to UK CGT on the grounds that the income was not chargeable to income tax.

7. The Natural Meaning of "Capital Payment"

Another broad brush approach is to argue that although the words "capital payment" are apparently defined, the definitions are not exclusive and one must, therefore, have regard to the natural meaning of the words. The natural meaning of "capital payment" is a payment of a capital nature. Just as capital gains tax is a tax on capital gains, so these Provisions aim to tax only benefits of a capital nature. One might point to the analogy of income tax cases where wide words such as "profits or gains" have been held to be limited to profits and gains which are of an intrinsically income nature.

A similar argument is based on the ordinary meaning of the word "payment", which suggests a positive action by the trustees. The word "payment" is notoriously ambiguous. It clearly covers a payment of money, whether the payment is an outright payment or not. The word "payment" is not always restricted to a transfer of money and can include, for example, transfer of the title to an asset.[9] The wording of s.97 suggests very strongly that all that the draftsman had in mind was (a) outright payments of money (b) payments of money in consideration of the undertaking of an obligation to repay them, i.e, loans, and (c) transfers of assets other than money. "Payments" within (b) and (c) would only have a "value" if made for less than full consideration. Hence, the conferring of other benefits, of an income nature, which can only be perceived of as benefits retrospectively by the effluxion of time and with hindsight[10], and where the perceived benefit arises not from the making of any *payment* but from the failure to exercise a right to require repayment, was not within the draftsman's purview.

9 See, for example, the discussion in my *National Insurance Contributions Planning* Chapter 6.

10 On valuation with hindsight, see the next section.

8. Valuation with Hindsight?

The superficial approach, like most superficial approaches, has the enormous advantage of being extremely easy and not requiring much intellectual thought. If, *at the end of a year of assessment*, one can say that a beneficiary has in fact had the benefit of a loan at a rate of interest less than that which he would normally have had to pay, then of course he has received a capital payment because a benefit has been conferred on him. This superficial approach commends itself to barristers, who are anything but superficial. The mere fact that it is a superficial solution does not mean that it is not also the correct solution. Moreover, it has the advantage that it would commend itself to a lazy or unable judge. By the time one comes to perform the annual calculation, one will know with hindsight what benefit the beneficiary has in fact received. That benefit was conferred by the trustees during the year, by their continuing omission to exercise a right, and is therefore received from the trustees. The benefit is clearly a valuable benefit and the only argument is as to the precise value of that benefit.

Hence, much turns on the point (or points) at which the valuation must be made. In my submission, if one follows the natural interpretation of the statute,[11] the amount of the capital payment is to be ascertained at the date at which it is made. Where the capital payment is "made by way of loan", the date the capital payment is made is clearly the date on which the loan is made. If the loan is repayable on demand,[12] then, as at that date, the benefit conferred has a zero value. If, however, one is allowed to consider the matter with hindsight, say, after each year of assessment is over, then the position is quite different. For in that case, the beneficiary will have enjoyed a benefit, if such it can be described, not by the making of the loan but by the failure of the trustees to call it in.

9. Received "from the trustees"

An important argument in favour of the taxpayer is that a benefit is not received "from" the trustees unless it is conferred at their expense. If there is no diminution in value of the trust fund, then nothing comes from the trustees. Now in reality, no benefit conferred by trustees is conferred by the trustees themselves. All benefits are conferred by the settlor. The trustees may in certain cases have a discretion as to which beneficiaries to benefit but in exercising their discretion they are simply perfecting the gift of the settlor.

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11 And we have received a salutary reminder in the judgment of the Court of Appeal in *Marshall v Kerr* on 3rd March that we must follow the natural construction of a statute unless there is some good reason to the contrary.

12 or is, on demand, to bear a commercial rate of interest.

Yet the position is not that simple. For capital gains tax purposes, trustees are deemed to be a quasi-corporation owning the underlying settled property.[13] That is why a transfer into settlement is a disposal of the entire property thereby becoming settled property notwithstanding that the transferor has some interest as a beneficiary under the settlement[14] and why on a person becoming absolutely entitled to settled property the trustees are deemed to dispose of it to him.[15] Interests in the settled property are treated as separate assets, rather in the way that shares in a company are separate assets from the company's own assets.

The trustees are not, however, deemed to own the *income* of the settled property. If, say, the trustees own shares in a company, and a dividend is declared and paid which as a matter of equity belongs to the tenant for life, nothing deems the trustees to own it for capital gains tax purposes. The same is true whether the dividend is paid in sterling cash or in some chargeable asset, such as a foreign currency or shares or securities in the same or another company. When the trustees fail to call in a favourable loan[16] and the benefit is thereby conferred on a beneficiary, it is a benefit of an income nature.[17] The benefit is conferred not at the expense of the trust fund but at the expense of those who would have been otherwise entitled to income. This feature is, of course, the most striking in the case where the person who would be entitled to the income is the borrower. If he has received a benefit, it is not only not from the trustees: it is not from anyone. Or at least not from anyone other than himself.

10. Anomalies

The taxation of income benefits as though they were capital leads to the most gross distortions and inequality. Consider the very simple case where settled property is held upon trust for A for life, remainder to B absolutely. The settled property comprises a mansion house, which has been occupied by A since 1980, and tenanted farms. The non-resident trustees sell part of the farmland for development and realise a substantial gain. Had there been no sale of the farmland, then it is clear that A would not have been taxable in respect of his beneficial occupation of the mansion house. He would indeed be enjoying a

13 TCGA s.60(1).

14 TCGA s.70.

15 TCGA s.71(1).

16 or, in the case of a loan where the trustees are entitled at any time to require a commercial rate of interest to be paid henceforth, fail so to require.

17 The benefit is not, of course, chargeable to income tax.

benefit of an income nature but one which is not chargeable to income tax.[18] Yet this is not some fancy tax avoidance which depends upon the use of trusts. It is equally true that all who own property which they enjoy ***in specie*** have an income tax advantage over those who pay rent for such enjoyment out of their income. That is a distortion of the income tax system which can be attacked on theoretical grounds and defended on practical ones. The distortion is nevertheless there and is fundamental to our system. It would be anomalous to levy a charge - to capital gains tax - only on certain beneficiaries of non-UK resident trusts, and that on a particularly capricious basis.

If the Revenue are right, then the realisation of the chargeable gain by the trustees would involve A in a very considerable charge to tax. In the year the gain is realised, say, 1992/93, he will have visited on him a chargeable gain equal to the benefit of free occupation since 10th March 1981 and will have a further capital gain visited on him annually. Yet A may not have benefited one iota from the trustees' sale. The proceeds of sale could have been so invested as to produce no additional income.[19] If, conversely, the sale proceeds had been invested so as to produce a greater income, then A would have been liable to income tax on the increased income. The real beneficiary will be B who will ultimately receive a trust fund of greater value. Yet, if the Revenue view is correct, he will find that part of his capital gains tax bill has been paid by A![20]

The anomaly becomes even more glaring when one appreciates that if the mansion house on the one hand and the income-producing property on the other hand had been contained in separate settlements on similar or even identical terms, there would have been no question of A being chargeable to capital gains tax in respect of his beneficial occupation of the mansion house as a result of a gain realised by the trustees of a separate settlement.[21]

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18 In the actual instance given, this is as the result of express legislation, as he would until thirty years ago have been taxable on the annual value under the old Schedule A.

19 Whether this was a proper course of action would, of course, depend on the terms of the trust instrument. In a modern well-drafted trust, the trustees would have the necessary flexibility.

20 Of course, such anomalies could also work to the disadvantage of the Revenue, as where A is either domiciled abroad or neither resident nor ordinarily resident in the UK.

21 As a planning point, in case the Revenue are ultimately held to be right, where all the property is contained in one settlement, the problem (if it exists) could well be solved or at least mitigated by an arrangement involving the hiving off of part of the trust assets to a new settlement.

11. Valuation

I do not consider in this article the difficult questions as to the precise valuation of the benefit conferred by a beneficial loan, if it is a capital payment of *some* value. I hope to address these questions in a future article. In the meantime, it must not be forgotten that difficulties in quantifying the value of an interest-free loan may indicate that it was not meant to be a capital payment of any value.